

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

Commissioner

MARC SPITZER

Commissioner

IN THE MATTER OF THE GENERIC)	DOCKET NO. E-00000A-02-0051
PROCEEDINGS CONCERNING ELECTRIC)	
<u>RESTRUCTURING ISSUE.</u>)	
IN THE MATTER OF ARIZONA PUBLIC)	DOCKET NO. E-01345A-01-0822
SERVICE COMPANY'S REQUEST FOR A)	
VARIANCE OF CERTAIN REQUIREMENTS OF)	
<u>A.A.C. R14-2-1606.</u>)	
IN THE MATTER OF THE GENERIC)	DOCKET NO. E-00000A-01-0630
PROCEEDINGS CONCERNING THE ARIZONA)	
INDEPENDENT SCHEDULING)	
<u>ADMINISTRATOR.</u>)	
IN THE MATTER OF TUCSON ELECTRIC)	DOCKET NO. E-01933A-02-0069
POWER COMPANY'S APPLICATION FOR A)	
VARIANCE OF CERTAIN ELECTRIC)	
<u>COMPETITION RULES COMPLIANCE DATES.</u>)	

TRACK B REBUTTAL TESTIMONY

OF

ALAN KESSLER

ON BEHALF OF

UTILITIES DIVISION

ARIZONA CORPORATION COMMISSION

November 18, 2002

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1 **Q. Please state your name and business address.**

2 A. Alan Kessler, 244 N. Main Street, Concord, NH 03301

3

4 **Q. By whom are you employed and in what capacity?**

5 A. I am a Managing Director of Accion Group, Inc., a consultancy providing
6 regulatory, strategic, operational and financial advisory services to a broad range
7 of clients, including electric, gas, and water utilities, regulatory agencies, and
8 other organizations involved in utility-related matters. My responsibilities include
9 coordinating our practice activities relating to services we provide in planning and
10 regulatory matters, as well as in business organizational issues.

11

12 **Q. Please discuss your educational background.**

13 A. I graduated from the City College of New York in 1969 with a B.S. degree in
14 Economics. In 1975, I was awarded a J.D. degree by Capital University. I have
15 also done graduate studies in Economics at the Massachusetts Institute of
16 Technology. Since graduation, I have continued my education by taking
17 professional education courses in finance, law, and economics.

18

19 **Q. Please discuss your professional experience.**

20 A. After graduation from the City College of New York, I was employed by the
21 Columbia Gas System as an economic analyst assigned to financial and asset
22 acquisition issues. Subsequent to law school, I was employed by the Public
23 Utilities Commission of Ohio as a hearing officer where I presided over rate, fuel
24 clause, and quality of services cases for electric, gas and telephone companies. In
25 1978, I joined the law department of Ohio Power Company where I was
26 responsible for all of the company's regulatory litigation. I was promoted to

1 General Counsel in 1984. In 1987, I joined the Utilities Consulting practice of
2 Ernst & Young, where I focused on advising clients on issues related to
3 financially distressed utilities. In 1998, I joined Deloitte Consulting, specializing
4 in mergers and acquisitions and regulatory matters. In 2002, I co-founded Accion
5 Group, Inc., my current employer.

6

7 **Q. Have you ever testified before any regulatory agencies prior to this**
8 **testimony?**

9 **A.** Yes. I have previously testified before the Vermont Public Service Board, the
10 New Hampshire Public Utilities Commission, the Public Utilities Commission of
11 Ohio, and the Federal Energy Regulatory Commission (FERC). Additionally, I
12 have testified on utility-related matters in bankruptcy court and before the New
13 Hampshire and Ohio legislatures. I have also advised clients on regulatory
14 matters before the utility regulatory authorities of New York, Michigan, Missouri,
15 Kansas, Virginia, Pennsylvania and California.

16

17 **Q. Would you please describe your role in the Track B proceedings?**

18 **A.** Accion Group, Inc. was retained by the Staff to assist in planning and facilitating
19 the four Track B workshops and to advise the Staff on matters relating to the
20 operations of competitive wholesale markets. Our assistance included advising
21 the Staff on the different approaches to conducting solicitations for wholesale
22 power employed in various markets, and how other regulatory bodies monitor
23 competitive solicitation processes. We assisted the Staff in preparing the Staff
24 Report that was issued on October 25, 2002. I participated in each phase of our
25 engagement and attended each workshop held.

26 **Q. Are you sponsoring the Staff Track B Staff Report?**

27 **A.** Yes, I am one of three witnesses sponsoring the Track B Staff Report.

1 **Q. What is the purpose of your Rebuttal Testimony?**

2 **A.** Several witnesses have expressed concerns relating to the Staff's proposed use of
3 a "price to beat." I will explain why the Staff proposed the approach and the
4 purpose to which the Staff intended to use the "price to beat" concept. I will
5 discuss APS' and TEP's approach to quantifying their unmet capacity and energy
6 needs, as presented in the Needs Assessments they filed on November 4, 2002.
7 Also, my testimony presents an amendment to the Staff Report that should be
8 considered by the Commission. This change results from discussions held at the
9 Workshop conducted on November 6, 2002, after the issuance of the Staff Report.
10 The amendment will clarify the Staff's position on the issue of how to define
11 "unmet needs." Finally, I discuss the Staff's position regarding communications
12 among the utilities, the Staff, the Independent Monitor, potential bidders, and
13 other persons having an interest in the solicitation process. Finally, I address the
14 Staff's position on issues raised regarding how renewable energy resources should
15 be treated in the initial solicitation.

16
17 **Q. Please summarize the workshop process and its impact on the Staff's**
18 **proposed solicitation process.**

19
20 **A.** Through the workshop process, the Staff successfully forged agreement among
21 the parties on nearly all of the issues surrounding a competitive solicitation. It is a
22 credit to all those involved that they came together to provide a consensus on
23 what would produce the best solicitation approach.
24 As the testimony of the parties shows, disagreement remains on a few important
25 points, such as how the amount of the solicitation will be determined and whether
26 pre-approval will be granted by the Commission.

1 **Q. How was the Staff solicitation proposal developed?**

2
3 **A.** The Staff used the workshops to first identify and then narrow the issues that
4 needed to be addressed in creating a competitive solicitation process. Next the
5 Staff circulated a draft proposal for comments from the workshop participants,
6 and conducted an additional one-day workshop to refine concerns of the parties
7 and provide an opportunity for the parties to reach agreement. Finally, the Staff
8 revised its solicitation proposal to incorporate workshop comments, and released
9 it to the parties.

10
11 **Q. Please discuss why the Staff proposed the use of a “price to beat.”**

12
13 **A.** Several workshop participants, including the utilities, sought an assurance that the
14 power contracts resulting from a solicitation would receive pre-approval by the
15 Commission through the use of an expedited prudence review. The utilities
16 wanted to mitigate the risk of a future disallowance of some or all of the cost of
17 purchase power. The merchants sought regulatory approval in order to make it
18 easier for them to assign the power contract proceeds as a financing tool.
19 The Staff believed that such a process was, and still is, unworkable because this
20 Commission is unfamiliar with the operation of competitive wholesale power
21 markets, and time is required for careful review of the reasonableness of the
22 Utilities’ decisions before full approval can be granted. In particular, the Staff
23 believes that both the bids selected and the reasonableness of each utility’s power
24 supply portfolio resulting from the addition to its existing power supplies of the
25 supplies selected will need thorough review. It is the Staff’s opinion that the
26 expedited approvals sought could not be issued in the time frame proposed

1 without unduly compromising its ability to conduct a meaningful analysis of the
2 complex issues that arise from redesigning a power supply portfolio.

3 At the same time, the Staff understands the parties' desire to have some indication
4 of the likelihood that specific contracts will not be challenged by the Staff when
5 the utility seeks to recover its costs from consumers. To address that need, the
6 Staff proposed to accept as reasonable, without further analysis, the prices
7 contained in specific contracts if they met certain conditions and were at prices
8 below the Staff's "price to beat." As proposed, the Staff would determine the
9 "price to beat" before bids were selected, based on the Staff's review of historic
10 and forecast market prices for delivery of capacity and energy in Arizona.

11 While the Staff Intention was to support contracts meeting the "price to beat", the
12 Staff did not propose finding all other contracts unreasonable or imprudent.
13 Rather, the Staff reserved judgment so it could, in a thoughtful manner, consider
14 whether the utility exercised reasonable business judgment and whether, when
15 taken as a whole, the utility's power supply portfolio was appropriate.

16
17 **Q. Why did the Staff decide not to disclose the "prices to beat" it established?**

18
19 **A.** The Staff chose not to disclose its "prices to beat" because such a disclosure could
20 bias the decision making process. If the "price to beat" is disclosed prior to
21 bidding, bidders are likely to use it as a target price. If it is disclosed subsequent
22 to bids being submitted but prior to contracts being entered, the utilities may skew
23 their selection to gain the Staff's support. Either result would diminish the
24 effectiveness of the solicitation process. Therefore, the Staff decided not to
25 disclose its "prices to beat", but rather proposed to simply announce which
26 selected bids met the "prices to beat" criteria.

1 **Q. Do the parties to Track B agree with the Staff's proposal?**

2
3 **A.** Based on the testimony of several parties, apparently not. Several would require
4 the Staff to disclose the "prices to beat," others believe it will be extremely
5 difficult to establish "prices to beat" while others apparently believe the Staff
6 proposal is inadequate to provide the assurances they seek.

7
8 **Q. Do utilities presently have their power supply purchases pre-approved by**
9 **this Commission?**

10
11 **A.** To the best of my knowledge, Arizona utilities presently do not have their power
12 supply contracts, or other contracts for goods or services, pre-approved by this
13 Commission. Rather, they exercise their business judgment and enter such
14 contracts in the normal course of business. Those contracts are generally only
15 reviewed at such time as their reasonableness is contested.

16
17 **Q. Which Staff witness will testify on the Staff's current proposal regarding**
18 **regulatory approvals?**

19 **A.** Mr. Johnson of the Staff addresses this issue in his filed testimony.
20

21 **Q. How does the Staff define the unmet needs for utilities?**
22

23 **A.** It is the Staff's belief that unmet needs should be defined as the difference
24 between a utility's capacity and energy requirements, and the amount of capacity
25 and energy that it has available to it at reasonable and competitive cost.
26

27 **Q. Please explain how the Staff determined the unmet needs of APS and TEP.**

1
2 A. As explained in the Staff Report at Page 7, the estimates contained in the Staff
3 Report were based on information provided to the Staff by the utilities during the
4 August workshops. The Staff used the capacity requirement and an average
5 system capacity factor provided by the utilities to develop the estimate of unmet
6 needs as presented in the Staff report. The Staff did not attempt to establish
7 precise estimates of the contestable capacity or energy requirements for either
8 utility because unmet needs are fluid. Under the Staff's approach, contestable load
9 and energy would be adjusted during the Pre-Solicitation phase of the process to
10 accommodate changes in projected load and system economics. Final unmet
11 needs are expected to be quantified prior to the issuance of the initial solicitation.

12
13 **Q. Did the utilities adopt that definition in preparing their needs assessments**
14 **filed November 4, 2002?**

15
16 A. No. In particular APS defined unmet needs as the difference between its forecast
17 load and all capacity and energy it was physically capable of producing,
18 irrespective of the cost of that generation.

19
20 **Q. Did this create a significant difference between what the Staff proposed as**
21 **unmet needs and what APS proposed?**

22
23 A. Yes. The current APS approach significantly reduced the amount of energy APS
24 proposed to solicit from what the company identified during the workshop.

25
26 **Q. Would the APS approach mean that APS would not competitively acquire**
27 **any significant amount of energy in the 2003 solicitation ?**

1

2 A. No. According to Mr. Carlson, APS would probably acquire a significant amount
3 of its energy requirement through competitive solicitations for both short-term
4 and economy energy. Mr. Carlson claims APS' approach would meet all of APS'
5 unplanned needs and that the as yet undefined subsequent competitive solicitation
6 for economy energy would displace higher cost APS generation when
7 opportunities to do so occurred.

8

9 **Q. How did APS propose to acquire that energy?**

10

11 A. APS proposed to acquire capacity and energy to cover what they call unplanned
12 needs and to purchase economy power, as it has in the past, by relying on the spot
13 market.

14

15 **Q. Does the Staff disagree with this approach?**

16

17 A. Not if the utilities make every effort to first solicit for all their unmet needs,
18 including an amount equal to or greater than their anticipated economy energy
19 requirements, in a fair and transparent solicitation.

20

21 **Q. Then why is there a dispute between the utilities and the Staff regarding the**
22 **level of unmet needs to be solicited in this initial solicitation?**

23

24 A. The Staff believes that for the initial solicitation each utility should seek bids for
25 all of the capacity it reasonably expects it will need for the periods it believes are
26 reasonable and for all of the energy it expects to purchase from third parties, in

1 order to determine market prices for both capacity and energy and to then assess
2 the risks of alternative supply scenarios.

3 The Staff believes the first solicitation should include (1) all of the additional
4 capacity, including reserves, the utility expects it will need for the periods
5 covered by the solicitation, and (2) all of the energy the utility expects to purchase
6 from third parties for specified time periods. Once bids are received, the utility
7 will be responsible for assessing the risks of accepting each alternative supply
8 scenario. In contrast, APS wants to solicit the capacity it will need, and then
9 procure short term and anticipated economy energy purchases from the spot
10 market, without evaluating the potential benefit of contracting for all unmet
11 energy needs.

12
13 **Q. Is there a fundamental difference between the Staff's proposal and the**
14 **utilities' approaches?**

15
16 **A.** Interestingly, there is not a fundamental difference. As APS witness, Mr. Carlson
17 stated, APS plans to solicit for three products: capacity only, capacity with
18 minimal energy, and physical "call" options. He also noted that subsequently and
19 as circumstances dictated APS would purchase economy energy.

20 The Staff believes that, in addition to the products APS proposes to solicit bids
21 for, it should also solicit bids for firm energy and dispatchable energy (whether
22 coupled with bids for capacity or not) in an amount equal to its total unmet needs
23 as defined by the Staff and as finally determined during the pre-solicitation phase
24 of the process proposed by the Staff.

25
26 **Q. What is the benefit of the approach supported by the Staff?**
27

1 A. First, it is important to remember that the Staff has taken the position that this
2 process is intended to enable each utility to manage its power supply portfolio in a
3 reasonable manner. The process is not intended to relieve the utilities of their
4 obligation to manage their businesses in a prudent manner, nor is it intended to
5 deprive the utilities of the means and flexibility they need to do so. Soliciting for
6 all of the energy reasonably expected to be purchased from third parties, that is to
7 say unmet needs as defined by the Staff, during the initial solicitation does not
8 obligate the utilities to purchase all of the power sought during the solicitation.
9 As the Staff clearly stated in its Staff Report at Page 16, the utilities have the right
10 to reject all bids if, based on a reasonable rationale, their opinion is that the bids
11 do not meet the needs of the utility and are not in the best interests of consumers.
12 For instance, a utility soliciting firm or dispatchable energy may find that firm
13 energy is available at prices that make the potential benefits of the spot market,
14 with its price volatility, unattractive. The utility may also find that dispatchable
15 energy is available at prices below the utility's marginal costs of generation.
16 Locking in that dispatchable energy during the initial solicitation will assure some
17 consumer benefits and still maintain the flexibility to go to the economy market
18 when circumstances dictate.

19 Q. **That sounds like a very different approach than the one presented by APS.**
20 **Is it?**

21
22 A. Not really. Mr. Carlson proposed a solicitation for call options on energy.
23 Call options as Mr. Carlson explains, give the Utility the right to take capacity and
24 energy at predetermined prices when it chooses consistent with the terms of the
25 option. In other words, the utility can in effect dispatch the capacity and energy.
26 Options are in fact a financial proxy for a contract for dispatchable energy.
27

1 **Q. Has the Staff recalculated its estimate of APS' and TEP's unmet energy**
2 **needs?**

3
4 **A.** We are still in the process of completing that analysis and will provide that
5 information as soon as it is available.
6

7 **Q. Does the Staff dispute APS' or TEP's quantification of their unmet capacity**
8 **needs?**

9
10 **A.** Yes. APS has quantified its needs based on a reserve level reflecting reserves
11 associated only with APS generation. They argue that firm capacity acquired
12 from third parties will provide reserves and therefore APS will not need to solicit
13 for those reserves. In effect, that approach limits APS' ability to decide when it is
14 most cost efficient to take and pay for reserves offered by bidders, and what cost
15 savings would be realized by APS providing its own reserves.

16 As Dr. Roach observed, reserves provided by bidders could easily be counted
17 against unmet needs. Recognizing bidders' reserves will also make it easier for
18 the Staff and the Independent Monitor to compare the merits of alternative bids as
19 the evaluation of bids is conducted.

20 The Staff also has concerns relating to the RMR capacity and energy needs
21 quantified by both APS and TEP. These concerns are addressed by Mr. Smith in
22 his testimony.
23

24 **Q. You mentioned earlier that you would present a change to the Staff Report.**
25 **Could you please identify that change and explain why it is being proposed?**
26

1 A. Yes, at Page 4 of the Staff Report, the Staff would insert the word “economically”
2 on line 20 before the word “served.” The Staff proposes this change to make it
3 clear that during the development of the solicitation process, the Staff’s intention
4 was to have the vast majority of reasonably expected purchases of capacity and
5 energy acquired through the process proposed by the Staff. The Staff was clear
6 that only power, capacity and/or energy to meet “unplanned needs” would be
7 acquired outside the process. Obviously, the utilities plan to make economy
8 purchases. After they conduct the initial solicitation and acquire all the capacity
9 and energy they deem to be appropriate as a result of that solicitation, they should
10 still take advantage of economy purchases if, and as, they are available. The Staff
11 believes the amount of anticipated economy energy should be solicited on a firm
12 or dispatchable basis, and then evaluated by the utility based on the information it
13 will acquire as a result of the solicitation, to determine whether contracts for
14 power are better alternatives than reliance on spot markets. As stated before, the
15 utility remains responsible for making, and justifying, Its decisions when
16 evaluating bids.

17
18 **Q. Several parties expressed concerns over how open the Staff’s process was**
19 **and how parties would communicate with the Staff, the Independent**
20 **Monitor, and the utilities. Would you care to comment on those concerns?**
21

22 A. Yes. The Staff made every effort to ensure that the process would be as
23 transparent as possible and as accessible to all parties as they could make it. The
24 Staff proposal was developed with the assistance of the workshop parties.
25 Particular interest was paid to transparency and preventing any potential bidder
26 from gaining an unfair advantage, especially utility affiliates.

1 The Staff's process is designed to encourage open and frank discussion of issues
2 as they arise. It is not the Staff's intention to hinder, in any way, the free flow of
3 conversation between bidders and the utilities, the access to data made available
4 as a result of the solicitation, or the ability of non-bidding parties to attend or
5 participate in meetings held by the utility to discuss their proposed bid packages,
6 or to keep from the utilities concerns developed by the Staff or the Independent
7 Monitor during the solicitation process. On the contrary, as indicated in the Staff
8 Report, there are mandated information requirements for the solicitation and
9 informational meetings to discuss that data, and there are defined obligations of
10 the Independent Monitor to communicate with all parties, including the utilities.
11 There are also requirements that communications by and between utilities and
12 their merchant affiliates with regard to the solicitation be monitored and
13 restricted. Also, all bidders should have access to the same data, so all
14 communications between utilities and bidders will be made available to all
15 bidders on a web site. The Staff believes that the standards set out in its proposed
16 process will allow the process to progress in an orderly and appropriate fashion.
17

18 **Q. Mr. Kendall, representing Wellton-Mohawk Generating Facility,**
19 **recommended in his Direct Testimony (pages 4 and 5) that in the competitive**
20 **procurement process, utilities give additional credit to renewable resources**
21 **for their public benefits. What is the Staff's position on this issue?**
22

23 **A.** The Staff believes that bidders of renewable resources should be
24 allowed to bid in this initial solicitation and that utilities should not be required to
25 give credit for the value of the renewable resource to the utility in meeting the
26 Environmental Portfolio Standard. However, whether such credits should be

1 required in subsequent solicitations should be considered in any future review of
2 the process adopted.

3

4 **Q. On page 17 of his Direct Testimony, Mr. Kendall recommends that**
5 **renewable resources be specifically solicited in Track B and that separate**
6 **renewables-only solicitations may be held as needed. What is the Staff's**
7 **position on this issue?**

8

9 **A.** The Staff believes that the utilities may solicit renewable resource products
10 through the competitive procurement process. In addition, renewables-only
11 solicitations may be held. However, utilities should be allowed to solicit
12 renewable resource products in the initial solicitation.

13

14 **Q. Does that conclude your testimony?**

15

16 **A.** Yes, it does.

17

18

19

20

21

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